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TAGS: ECON EFIN PGOV PREL CO
SUBJECT: 2003 REVIEW OF THE COLOMBIAN ECONOMY

¶1. (SBU) Summary: The Colombian economy performed well during President Alvaro Uribe's first year in office and will end 2003 on a positive note. A significant increase in exports to the United States helped stabilize an economy constrained by the internal armed conflict and challenged by a significant decrease in trade with Venezuela, the country's second largest trading partner. GOC improvements in security and restructuring of inefficient parastatals also helped keep the economy on track, despite the failure of President Uribe's reform referendum. Various indicators point to a healthy economy in 2004, provided there is sustained private investment and household consumption. However, alarming social indicators, lingering fiscal problems, and a lack of needed reforms may jeopardize future economic growth and stability. End summary.

The Colombian Economic Recovery

¶2. (U) The Uribe administration is committed to attracting foreign investment by improving the security environment and opening Colombia's economy through liberal trade regimes and free trade agreements. Uribe's first-year performance, coupled with the prospects of negotiating for freer trade with the United States, has improved business and consumer confidence. The general reaction has been so favorable that the first three quarters of 2003, which exhibited broad-based growth, were some of the most stable in Colombia's history. For example, according to the National Administrative Department of Statistics (DANE), mining and fuels rose 12.4 percent year-on-year (led by Colombia's two largest exports, oil and coal), and construction grew 9.8 percent. Other sectors such as manufacturing, trade and tourism, transport, communication, and agriculture grew approximately 4.5 percent year-on-year. During the first half of 2003, the economy grew 2.9 percent compared with 1.1 percent growth for the same period last year. The third trimester ended on a high note, registering approximately 4.17 percent growth. The GOC expects 3.4 percent growth overall for 2003, and projects that increases of 8.5 percent in private investments and 3.2 percent in household consumption will yield 3.3 percent growth for 2004.

¶3. (U) Consumer spending, imports of capital goods, and home purchases continue to fuel the economy. Several other economic indicators point to improvement:

-- According to the National Federation of Businessmen (FENALCO), 43 percent of retailers reported an increase in sales. The Banking Association (ASOBANCARIA) reported that credit card sales and advances have risen at a rate of more than 20 percent, as have consumer loans in general. The National Association of Industrialists' (ANDI) most recent business poll indicated that the industrial sector recorded growth of 2.7 percent in output and sales from January to November compared to the same period last year.

-- Domestic spending, which affects both demand for credit and the repayment capacity of non-tradable sectors, has posted significant increases dating back to the second quarter of last year.

-- The GOC raised the minimum wage 7.8 percent to USD 127 per month -- the largest real increase in purchasing power of the last 12 years. Approximately four million Colombians, or ten percent of the population, earn minimum wage.

-- According to the Colombian Savings and Housing Institute (ICAV), foreclosures are down and bank inventories are getting smaller.

-- The Agriculture Ministry and the Association of Colombian Farmers (SAC) predict that this year agricultural production will grow 5 percent, an estimate based on 147,000 new hectares that were planted this year, with palm oil, corn, cacao, rubber, and rice leading the way. The most recent National Agricultural Poll revealed that agriculture is now the third most important sector of the economy, representing 14.2 percent of the GDP. (Note: SAC reports that although the agricultural sector has been growing during this year, it is not profitable. Despite higher prices and increased crop

cultivation for the first semester of the year, production costs have increased significantly as a result of the increased prices of fuel and fertilizers. End note.)

-- Employment is up. The DANE reported that the overall unemployment rate stands at 14.3 percent. Through the third quarter of this year approximately 900,000 new jobs were created, representing an increase of 5.7 percent compared to the same period in 2002.
-- For the period between January and September 2003, foreign direct investment (FDI) from all countries totaled USD 1.5 billion. The stock of U.S. FDI in Colombia through September 2003 amounted to USD 8 billion.

Exports, Boosted by ATPDEA, Have Led the Way

¶4. (U) Total Colombian exports were eight percent higher than last year, despite the halt in exports to Venezuela, Colombia's second-largest export market. Exports to the United States have more than made up the difference. The U.S. market receives 44 percent of all Colombian exports, more than two-thirds of which enter tariff-free. During 2003, total Colombian exports to the United States were USD 5.4 billion. Colombia exported USD 2.4 billion under the Andean Trade Preferences and Drug Eradication Act (ATPDEA). Considering just textiles, more than USD 158 million in exports benefited under ATPDEA in 2003, an improvement of 48 percent over the previous year.

Increased Security Pays Off

¶5. (U) Uribe's proactive security strategy has delivered important results: illegal armed groups have been weakened, and terrorist attacks and overall violence have declined. These improvements have facilitated increased production. Businesses reported in a survey conducted by the Colombian Association of Small Industries (ACOPI) that "lack of security" decreased from representing 13 percent of their concerns in 2002 to 5.4 percent in 2003. This improvement has helped businesses to increase use of installed capacity to 74.6 percent.

¶6. (U) Drummond Coal Company is an example of a firm that has benefited from improved security: in its 12 years in Colombia, the company has been successful in reducing attacks on its infrastructure and in broadening local support for its extractive operations. According to Drummond's local President, Augusto Jimenez, future plans include investing approximately USD 1.5 billion over the next five years to develop new coal projects, creating almost 7,000 new jobs, and exporting more than 30 million tons of coal.

¶7. (U) Road traffic has also risen as a result of improved security. Alicia Naranjo, Director of the National Roads Institute (INVIAS), reported that overall vehicular traffic increased 7.3 percent. The increase in Colombians flocking to rural areas during holidays and vacations has stimulated new sectors of commerce in regions previously neglected.

Restructuring Inefficient Parastatals Helps Too

¶8. (U) President Uribe also undertook a major effort to cut overall government expenditures and restructure inefficient parastatal entities, which were operating at unsustainable levels and putting significant strain on the economy. The State Petroleum Company (Ecopetrol), Telecom, and the Social Security Institute (ISS) were the largest entities affected. In an effort to salvage the entities, thousands of unneeded employees collecting inflated salaries and benefits were laid off. The enterprises are now compelled to be more efficient or destined to disappear in competition with the private sector. Colombian unions responded with strikes, but received scant public support. The GOC estimated it will save over USD 9.2 billion, and believes that the changes have brought about viability and governability.

-- Ecopetrol: Through decree 1760, the GOC converted Ecopetrol, which remains a government-owned enterprise, into a corporation that will handle field operations, and created the National Hydrocarbons Agency, which will set petroleum policy and handle royalties from new contracts. The restructuring did not result in any significant layoffs, changes in work contracts or the collective bargaining process. The "new" Ecopetrol allows employees to become shareholders, who can then appoint a board of directors tasked with increasing accountability and fighting corruption.

-- Telecom: Telecom was liquidated after operating at unsustainable losses for several years. This decision

resulted in the firing of 5,260 Telecom employees and 1,651 employees from associated telecommunications enterprises. The GOC created a new State-owned institution, Colombia Telecomunicaciones, which permits the State to continue providing service throughout the country, particularly in 750 areas where Telecom will be the sole provider.

-- Social Security: Presidential decree 1750 will split the ISS, the largest government enterprise, into one insurer and seven State Social Enterprises (ESE). The new ESEs, which will be administratively autonomous with their own budgets, will provide health services while the ISS will manage pensions, worker's compensation, and social security. Uribe's reform is long overdue, given that ISS is fast exhausting its reserves, forcing the government to come up with USD 596 million (1.7 trillion Colombian pesos) to pay for benefits.

As Does Sound Monetary Policy

¶9. (U) The GOC strategy of keeping interest rates low and maintaining a competitive exchange rate has spurred economic recovery. In the first semester of 2003, interest rates remained low, allowing for recovery of credit. Furthermore, in response to inflationary pressures, the Central Bank increased intervention rates twice, and held two actions of international reserves for USD 200 million each. As a result, interest rates have risen slightly, and foreign exchange rates have stabilized. The 2003 target rate for inflation is 6 percent, although inflation stood at 6.5 percent as of December 2003. The 2004 target rate is 5.5 percent.

¶10. (U) Near-term fiscal finances are under control. The consolidated public sector deficits in 2003 and 2004 should be just slightly above the 2.8 and 2.5 percent of GDP deficit targets. The GOC has offset the shortfall resulting from the referendum's defeat by raising taxes, reallocating transfers to regional governments, and by cutting investment spending.

Moving on After the Referendum Defeat

¶11. (SBU) The GOC promoted a referendum to reform constitutional norms that have impeded important spending cuts. Although voter turnout was just short of the 25 percent threshold required for approval, voters overwhelmingly supported the reform agenda. The referendum's failure does not appear to have hurt private confidence, which remains strong due to important gains on the security front. The popularity of President Uribe remains in the high 70s.

¶12. (U) In order to make up for the loss of several cost-cutting measures in the referendum, the Uribe administration introduced new economic austerity legislation that faced opposition in Congress. Changes to the VAT and income tax regimes, which were at the heart of Uribe's tax reform proposal, were severely watered-down. The tax bill, which passed in an extraordinary congressional session, provides USD 817 million, but leaves a USD 286 million gap to be bridged by spending cuts. Measures include taxes on wealth, personal income, financial transactions, anti-evasion policies, and an expansion of the tax base.

¶13. (U) The GOC has loan commitments from international financial institutions (IFIs) of USD 7.2 billion for the 2004-2005 period, including USD 2 billion in contingent credit from the IMF. Many of these loans require continued structural reforms, further strengthening the link between the Uribe administration's ability to carry out reform and a healthy economy. Pending reforms include a reform to the budget code, a third-generation reform to social security, and second-generation reform to inter-governmental (territorial) transfer arrangements.

There is Still Room for Improvement

¶14. (SBU) The National Council for Economic and Social Policy (CONPES) reported that economic growth for 2004 would rest on sectors such as construction, industry, transportation, and finance. Although the economic environment is generally positive, Uribe still faces considerable challenges.

¶15. (SBU) The gaping budget shortfall is the most pressing. Many Colombians have spoken out against the reform efforts. On the one hand, critics feel that legislation passed so far is only a temporary bandage masking the need for substantial reform. On the other hand, some in the business community expressed fear that a cascade of new taxes and other fiscal belt-tightening could adversely affect consumption and

investment and undermine the nascent economic recovery. The GOC has proposed a USD 28 billion budget for 2004. Due to the fiscal crisis, public spending will have little influence on jump starting the economy. The GOC may use a modest amount of reserves for liability management operations in 2004, which, at the margin, could support bond prices.

¶16. (SBU) Debt continues to be a problem. Comptroller General Antonio Hernandez stated in a report to congress that the GOC's debt level compromises the economy's external sustainability. Worse yet, projections to 2006 show a more marked vulnerability. Hernandez predicted a balance of payments crisis in the future unless the government takes corrective action. He reported the non-financial public sector's net debt last year stood at 51.5 percent of GDP (USD 39 billion), or 7.5 percent higher than 2002. Foreign debt accounts for 48.2 percent of this total. (Note: Analysts who evaluate the actual cost of foreign debt suggest that the government should resort to borrowing from multinational banks to a greater extent and start minimizing costly financing avenues such as issuance of foreign bonds. Increasing reliance on the latter has led to the adoption of new ways to finance infrastructure projects -- concessions, joint venture contracts, and power purchasing agreements -- that have become financially onerous for the nation. End note.)

¶17. (SBU) Social indicators continue to alarm. Faster population growth and a devalued peso contributed to a fall in the dollar value of per capita GDP from USD 2,110 in 2001 to USD 1,852 in 2003. The percentage of the population living in poverty remains at 60 percent, extreme poverty exceeds 35 percent, and the underemployed represent 34 percent of the labor force. Though unemployment has declined in the past two years, it remains relatively high and is one of the factors weighing on domestic sentiment. The plight of 1.5 million jobless Colombians in the country's 13 largest metropolitan areas is dramatic. This worries Uribe as well as private sector leaders, who insist on the urgent need to adopt "shock" measures to deal with unemployment.

Outlook for 2004...

¶18. (SBU) Comment: The outlook for the near future is promising, but some key questions must be answered if economic growth at relatively high levels is to be sustained:
-- Can the GOC stem the growth of the international debt? The corollary question of whether the GOC can tame its fiscal deficit must also be answered affirmatively.

-- Can the fiscal deficit be brought under control in what is effectively a wartime budget without reducing security or social expenditures below politically acceptable minimums?

-- Will Colombia's export prices hold and will the U.S. economy continue to be a strong market for Colombian exports?

-- Will the opposition to Uribe continue to support sound economic policy for the latter part of his term?

If the answers to the above questions are affirmative, Colombia's near and medium-term prospects are bright. End comment.
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